

MEMORANDUM

September 24, 2013

TO: Government Operations and Fiscal Policy Committee

FROM: Stephen B. Farber, Council Administrator *SBF*

SUBJECT: Briefing – Implementation of GASB Standards No. 67 and 68 – Pension Accounting and Financial Reporting

The Committee is to receive a briefing on steps the County Government is taking to implement two new standards issued by the Governmental Accounting Standards Board: No. 67, *Financial Reporting for Pension Plans*, and No. 68, *Accounting and Financial Reporting for Pensions*. The presentation is attached on ©1-19.

Those conducting the briefing include Joseph Beach, Director, and Lenny Moore, Controller, of the Department of Finance, and Thomas Rey, Partner, CliftonLarsonAllen LLP, external auditor for the County and its retirement plans. Others in attendance include Karen Hawkins, the Department's Chief Operating Officer; Linda Herman, Executive Director, and Brad Stelzer, Senior Portfolio Manager, Montgomery County Employee Retirement Plans; and Amy Williams, Consultant, Gabriel, Roeder, Smith & Company, actuary for the County's defined benefit pension plan, the Employees' Retirement System (ERS).¹

Consistent with past practice, the County has been proactive in addressing the new GASB standards. A decade ago, when GASB first issued exposure drafts of Statement No. 45, *Accounting and Financial Reporting by Employers for Post-employment Benefits Other than Pensions* (OPEB), this Committee (then known as the Management and Fiscal Policy Committee) initiated periodic meetings with the budget, finance, and legal staffs of the County and bi-county agencies: MCG, MCPS, Montgomery College, M-NCPPC and WSSC. A Multi-Agency OPEB Work Group reported regularly to the Committee on its progress.² While this

¹ As of June 30, 2013, the ERS had assets of \$3.2 billion, with 4,235 active participants and 5,518 retirees. The estimated funded status was 78 percent.

² The agencies' OPEB funding levels have steadily improved. Total tax supported OPEB funding has risen from 0 in FY11 (because of recession-related fiscal pressures) to \$49.6 million in FY12, \$105.4 million in FY13, and \$138.0 million in FY14. The current target for FY15 is \$182.4 million. In 2011 the Council created the Consolidated Retiree Health Benefits Trust to further strengthen performance.

briefing on the new GASB standards focuses on County Government, the other agencies have also started to address them, and further interagency collaboration will ensue.

The presentation of the new GASB standards on ©1-19 provides a clear outline of their objectives and probable effects. Key points include the following:

- Since the focus is on accounting and reporting rather than funding, neither statement is expected to significantly affect the ERS' funded status (©5-6)
- Non tax-supported funds and outside agencies may see an increase in pension expense and total liabilities.³ While the new standards do not affect contributions and funding of the plan, the "more comprehensive expense" that must be recognized may require a change in funding strategy (©7).
- GASB 68 itself should not affect the County's bond ratings. Under a stricter test developed by Moody's Investors Service, the County is well below Moody's threshold for placing AAA governments on its watch list (©8).
- The appendix, starting on ©12, provides further information on the decoupling of pension accounting from pension funding and on accounting changes that affect both the ERS and the County.

Other useful summary information on the new GASB standards and policy guidance on pension funding can be found in *Pension Funding: A Guide for Elected Officials*. The guide was prepared by a Pension Funding Task Force comprised of representatives from the "Big Seven" national organizations of state and local elected officials and GFOA and other public finance professionals. See ©20-25.

The new GASB standards coincide with the growing national focus on the condition of state and local pension funds. The pension problems confronting such jurisdictions as Detroit, Chicago, and Illinois are well known. Others, even with a strong economy and effective management, are also affected. For example, earlier this month Omaha lost its AAA rating from Standard & Poor's and received a negative outlook revision from Moody's.⁴

³ The "outside" or "participating" agencies and political subdivisions are the Town of Chevy Chase, Strathmore Hall Foundation, Housing Opportunities Commission, Revenue Authority, Washington Suburban Transit Commission, Montgomery County Employees Federal Credit Union, independent fire/rescue corporations, and certain employees of the State Department of Assessments and Taxation and the District Court of Maryland.

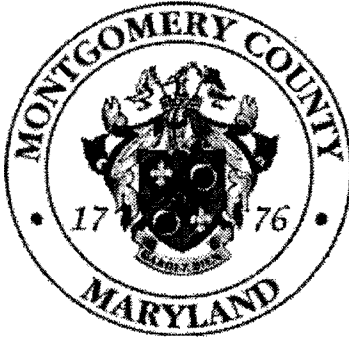
⁴ Moody's cited "the continued pressures posed by the magnitude of Omaha's unfunded pension liability, both nominally and as a percentage of operating revenues; the habitual underfunding of the pension plans' actuarially determined annual required contributions; and the limited ability to reduce pension costs or willingness to raise revenues to cover pension costs."

For an assessment of the challenges confronting both public and private sector pension plans, see the essay by Roger Lowenstein on ©26-27. Sources of useful background information on the challenges for public plans include *The Funding of State and Local Pensions: 2012-2016*, a brief from the Center for Retirement Research at Boston College, and *The State of State Pension Plans 2013*, a report from Morningstar. The links are:

<http://crr.bc.edu/briefs/the-funding-of-state-and-local-pensions-2012-2016/>

<http://corporate.morningstar.com/US/documents/Retirement/StateofPensions2013.pdf>

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Governmental Accounting Standards Board Implementation – Statements 67 & 68 - Pensions

Government Operations and Fiscal Policy Committee
September 26, 2013

Overview

- What is GASB? What is its role?
- What are the new GASB standards?
- What is the intended impact of the new standards?
- Will the new standards increase County budget pressures?
- Will the new standards impact the County's bond ratings?
- Actions required to implement the new standards.

What is GASB? What is its Role?

- The mission of the Governmental Accounting Standards Board (GASB) is to establish and improve standards of state and local governmental accounting and financial reporting to assist users of financial reports, including issuers and auditors, and to guide and educate the public.
- GASB standards for public-sector pension plans were first issued in 1986 and updated in November 1994 with the issuance of GASB Statements No. 25 & 27.
- Various factors led to a decision to revise the accounting standards including:
 - Refinements of GASB's accounting theory
 - Development by other standards-setting organizations of accounting standards based on a mark-to-market approach (refers to valuing and recording assets at the current market value)

What are the new GASB Standards?

- Statement No. 67, Financial Reporting for Pension Plans
 - ❑ Affects state and local government pension plans
 - ❑ Replaces Statement No. 25
 - ❑ Effective **FY14**

- Statement No. 68, Accounting and Financial Reporting for Pensions
 - ❑ Affects the government sponsors/participating employers
 - ❑ Replaces Statement No. 27
 - ❑ Effective **FY15**

What is the Intended Impact of the New Standards?

■ Statement No. 67- will improve “ financial reporting primarily through enhanced note disclosures and schedules of required supplementary information.” *Doesn’t impact economic position.*

■ Statement No. 68- will improve “the decision-usefulness of information in employer...financial reports... by requiring recognition of the entire net pension liability and a more comprehensive measure of pension expense.” *Doesn’t worsen overall economic position, as this was already disclosed in the footnotes to the County financial statements.*

■ At the present time neither statement is expected to significantly impact the funded status of the Employees’ Retirement System.

Will the new standards impact the County's budget?

The new standards, in and of themselves, will not.

- Focus is on accounting and reporting
- Key accounting impacts – “more comprehensive expense”
 - ❑ Recognizing expense based on full actuarial cost, not just funded portion
 - ❑ Accelerating the recognition of pension changes
 - ❑ Accelerating recognition (eliminating smoothing) of investment gains/losses
 - ❑ Standardized actuarial cost method (entry age normal)
- Will be some impacts on plan sponsor/participating employer expense
- Silent on funding, effectively decoupling pension funding and pension accounting standards

Will the new standards result in the County paying higher pension costs?

It depends on funding strategy

- Existing standard coupled accounting and funding together so that pension costs and liability were related to systematic funding amounts (e.g., ARC/APC).
 - Effect of new standard on accounting/budgeting expense:
 - Tax-supported funds:
 - Will not in general change the accounting, and therefore the budgeting, for tax-supported funds
 - Instead it will affect the “top-level” government-wide financial statements
 - Non tax-supported (enterprise, internal service) funds and certain outside agencies:
 - Expected to increase pension expense and total liabilities
 - May have an impact on rates, transfers, and other budget-dependent transactions
 - Although the standards are silent in regard to funding, the “more comprehensive expense” required to be recognized in enterprise funds and outside agencies may require a change in funding strategy.
-

Will the new standards impact the County bond ratings?

- By itself, GASB 68 should not affect bond ratings in most cases -- rating agencies knew where to find the numbers before.
- Factors that may affect ratings:
 - New algorithms and treatments by rating agencies
 - Local and global economy
 - Financial condition of the government
 - Other changes
- Gabriel, Roeder, Smith & Co. (the ERS' actuary) recently calculated the impact on the County. The County currently appears favorable to using the rating agencies' criteria. For example, Moody's "normalizes" governmental pension liabilities for comparability by using lower "market-like" discount rates, using actual market value of assets and other adjustments.
- The table below shows Moody's analysis for the County. Based on the ratio of Net Pension Liability to Operating Revenues, the County is well below Moody's threshold for placing AAA governments on its watch list.

Discount Rate	7.50%	5.50%	4.00%
"Net Pension Liability" (NPL)	\$877MM	\$1,874MM	\$2,858MM
FY11 Operating Revenues	\$2,842MM	\$2,842MM	\$2,842MM
NPL/Operating Revenues	0.31	0.66	1.01

Moody's is placing AAA governments with 3.00 or higher on watch list.



- Standard & Poor's announced on 9/12/13 that they are revising their ratings criteria. We are evaluating the changes.

Current Workplan

Action Step	Status	Estimated Due Date
Planning meetings with actuaries and external auditors	Ongoing	December 2013
Discussions with bond counsel and the rating agencies	Ongoing	December 2013
Calculation of the blended rate	Completed	July 2013
Discuss whether it makes sense to use the same actuarial cost method for the funding valuation as required for accounting calculations	Based on results of actuarial valuation	November 2013
Analyze the impact on the funding valuation results of changing the cost method from the projected unit credit cost method to the entry age normal cost method	Based on results of actuarial valuation	November 2013
Prepare a pro-forma of the annual pension expense and NPL under the new accounting standards	Based on results of actuarial valuation	November 2013
Determine recommended long-term funding policy in light of the GASB changes	Ongoing	June 2014
Discuss allocation methodology for Enterprise Funds	Based on results of actuarial valuation	June 2014
Develop a methodology for the allocation of the plan's NPL and annual pension expense to each participating employer	Based on results of actuarial valuation	June 2014
Discuss additional employer accounting questions	Based on results of actuarial valuation	August 2014

Appendix Materials

Employees' Retirement System – Current Status

(all dollar values stated in millions)

	June 30, 2012	June 30, 2011	June 30, 2010	June 30, 2009
Market Value of Assets	\$2,937	\$2,897	\$2,443	\$2,176
Actuarial Value of Assets*	\$2,891	\$2,869	\$2,791	\$2,766
Actuarial Value of Assets/Market Value of Assets	98%	99%	114%	127%
Difference (MVA-AVA)	\$45	\$28	(\$348)	(\$590)

Funded Status *	77%	77%	77%	78%
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Unfunded Liability	\$877	\$875	\$854	\$753
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* Funded Status is the portion of the liability covered by plan assets, as calculated by the actuary.

Major Changes – GASB 67 & 68

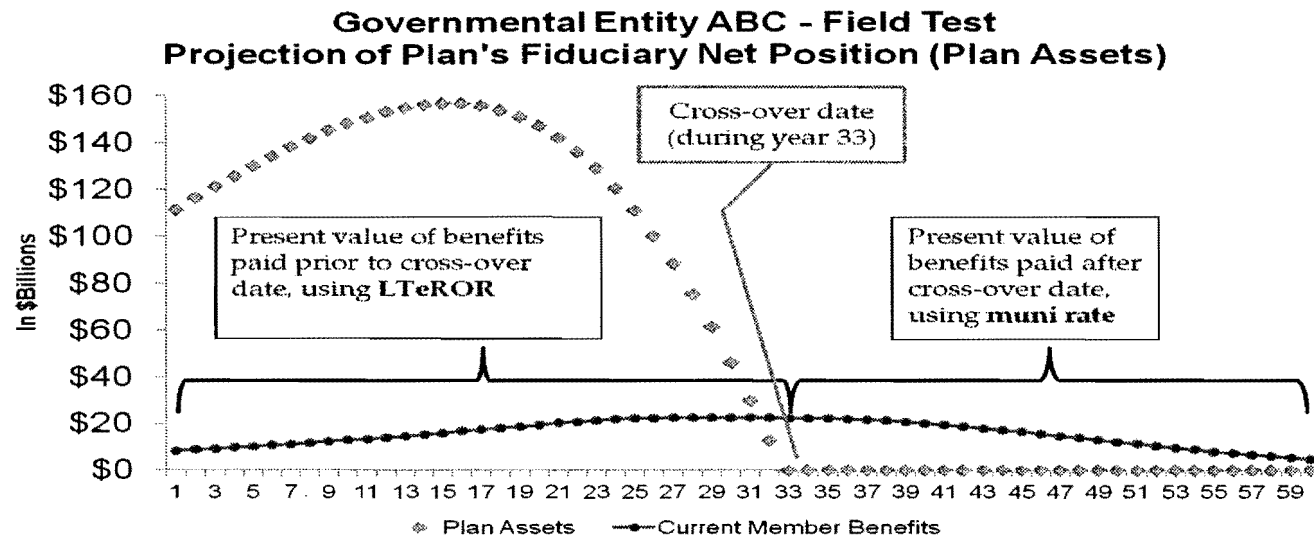
- Decoupling of *pension accounting* from *pension funding*
 - Employers can now use a different methodology for computing and reporting the liability for “accounting for it” versus “funding for it”
- Accounting changes impacting the retirement plan
 - No “smoothing” of assets (gains/losses over 5 years)
 - May require use of a blended discount rate in computing liability
 - Stricter amortization requirements
 - Change in actuarial cost method used in computing liability (from 6 alternatives to 1)
- Accounting changes impacting the County
 - Reporting of net pension liability on balance sheet (prior reporting was only a footnote disclosure)
 - Reporting of more conservative measure of pension expense
 - Changes to footnote disclosures and supplementary information

Disconnect Pension Accounting From Pension Funding

Current: The County currently use the same measures for accounting and funding. Under the new GASB statements, the two are disconnected:

	Funding Purposes	New Required Accounting
Discount Rate	Long-term rate of investment return	Long-term investment return and potentially a municipal bond rate (blended rate)
Asset Valuation	May be smoothed	Fair (market) value
Amortization	Considerable flexibility	Strict requirements and likely shorter periods
Actuarial Cost Method	Considerable flexibility	Traditional entry age normal

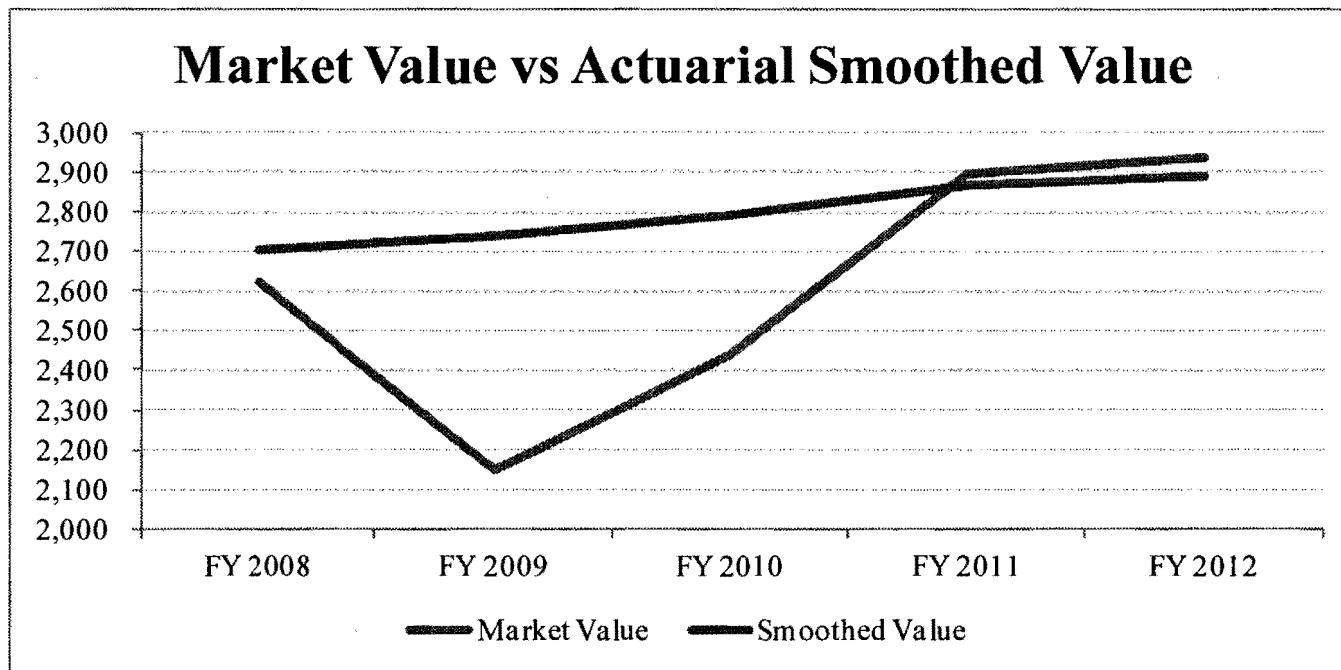
Plan Use of Blended Discount Rate



- The blended rate is based on the Plan's investment return assumption, 7.50%, for the portion of current member benefits that are funded and a municipal bond rate for the portion of current member benefits that are not funded.
- Based on the County's current funding policy, current member benefits are fully funded by the applicable assets.
- Therefore, the use of a blended rate is not required.

Retirement Plan Impact – Smoothing of Gains/Losses

- Recognizes the difference between the expected investment return using the valuation assumption of 7.5% and the actual investment return over a 5-year period
 - Smoothing dampens volatility of contribution rates
 - Current aggregate actuarial value about 98% of market value



Retirement Plan: Change in Actuarial Cost Method

- The new accounting standards require the use of a specific actuarial cost method -- the traditional entry age normal actuarial cost method.
 - This is different than the projected unit credit cost method, which is the method currently being used for the funding valuation.
 - The actuary's preliminary assessment is that the entry age normal cost method results in a lower normal cost and higher actuarial liability, which produces both lower contribution rates and a lower funded ratio.

Requires the County to begin recognizing the Net Pension Liability (NPL) on its balance sheet

*Moves the unfunded liability from the footnotes in the County's financial statements to the balance sheet.**

Current Standards

Net Pension Obligation
equal to cumulative difference
between Annual Required
Contributions and actual
contributions

County's Balance Sheet
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Footnote: \$877 Million in UAL



New Standards

Net Pension Liability equal to
Total Pension Liability minus
the Plan's Fiduciary Net
Position (basically the
unfunded liability)

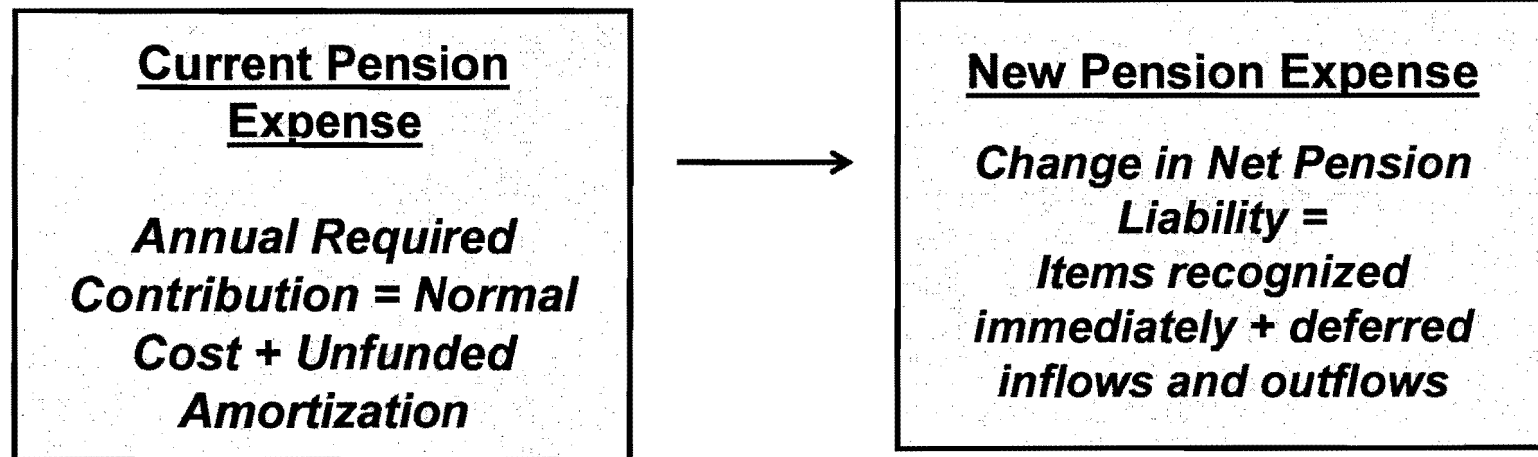
County's Balance Sheet
\$ 877 million

* The dollar amounts shown in the boxes relate only to the impact of the pension change.

Requires County to recognize a new measure of the Pension Expense (PE) on its income statements

Annual pension expense no longer based on Annual Required Contribution (ARC)

- Under previous Statement 27, pension expense was equal to the Annual Required Contribution (“ARC”) plus some adjustments. The ARC was basically equal to normal cost plus amortization of the unfunded liability over a period no longer than 30 years.
- Under Statement 68, pension expense largely represents the change in NPL from the prior year with provisions for deferring certain items.



County – Changes to Footnotes

- Replace most of the current note disclosures and required supplementary information with information based on the new measures



Understanding New Public Pension Funding Guidelines and Calculations

The importance of properly financing state and local government retirement systems has never been greater. Sound pension funding policies not only help ensure costs and benefits remain sustainable, but also strengthen the financial position and credit rating of the sponsoring governments.

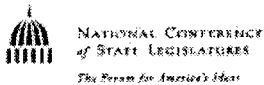
State and local governments soon will need to distinguish several separate pension calculations that will be derived in different manners for distinct purposes:

- *Books* – computing an annual position regarding pensions for financial statements
- *Bonds* – calculating how pension obligations affect a government's creditworthiness
- *Budgets* – determining the appropriate annual contribution to the retirement system for sound funding

The Governmental Accounting Standards Board (GASB) has released new standards for how governments should report pensions on their books or income statements. Some credit ratings agencies have announced that they will make new adjustments to governmental pension data for bond ratings. However, none of these computations is intended to determine the appropriate annual pension contribution a government should appropriate to ensure sound funding.

To guide lawmakers in reviewing the effectiveness of existing funding policies and practices, national organizations representing the nation's governors, state legislatures, state and local officials, and public finance professionals jointly formed a Pension Funding Task Force and released *Pension Funding: A Guide for Elected Officials*.

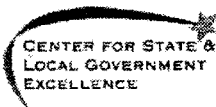
These guidelines urge policymakers to ensure pension contributions are actuarially determined within sound parameters. Doing so ensures that pension promises can be paid, employer costs can be managed, and the policy to finance pensions is clear to all stakeholders.



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Separate Pension Numbers for Books, Bonds, and Budgets

	Books	Bonds	Budgets
Purpose	Standardized financial reporting of pensions for accounting	Stress testing the degree to which pension obligations may affect a government's ability to repay bonded debt	Determining an annual pension contribution to properly fund benefits
Primary audience	Users of government financial statements	Ratings analysts	State/local policymakers
Source of calculation	Accounting standards set by the Governmental Accounting Standards Board (GASB)	Practices established by individual credit rating agencies	State/local statutory, administrative and procedural rules
Methodology	Pensions are accounted for through the computation of a Net Pension Liability, i.e., the difference between the market value of pension fund assets and benefit obligations as of a specific date	Varies by rating agency, as pensions are just one of many metrics used to determine a bond rating	Most governments make actuarially determined contributions, calculated within established parameters as a level percentage of payroll to fully fund benefits earned each year and to amortize unfunded liabilities
What's changing	The Net Pension Liability is a new figure that will be placed on basic government financial statements and is expected to create unprecedented volatility and, in some cases, could dwarf other items on the financial statement	Some ratings agencies have announced that in their credit analytics, they will adjust pension data using uniform, generally more conservative assumptions regarding amortization periods and investment returns	New GASB standards will no longer include parameters for calculating an annual required contribution. Although this does not necessitate a change to existing funding policies or statutes, governments are urged to follow recommended guidelines established by the Pension Funding Task Force

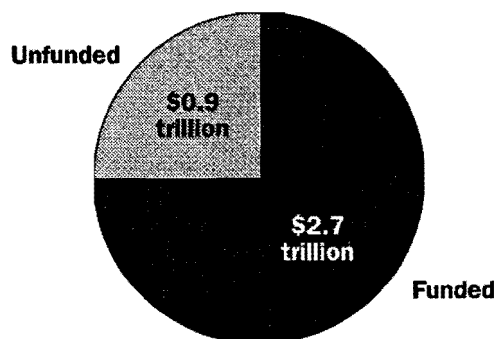
PENSION FUNDING:

A Guide for Elected Officials

Introduction

Defined benefit pension plans have a long history in public sector compensation. These plans are typically funded through a combination of employer and employee contributions and earnings from investments. Public pension plans hold more than \$3 trillion in assets in trust on behalf of more than 15 million working and 8 million retired state and local government employees and their surviving family members. The pie chart below illustrates the 2011 funded status of 109 state-administered plans and 17 locally administered plans. These plans represent 85 percent of total state and local government pension assets and members.

Figure 1. Funding of Aggregate Pension Liability, 2011



Source: BC-CRR Estimates based on Public Plans Database (PPD).

The value of securities held by public and private retirement plans declined significantly following the economic crisis of 2008–2009, causing an increase in unfunded pension liabilities. The range of those unfunded public pension liabilities varies widely among governments. These same governments also have enacted major changes in their retirement plans over the past decade. Today, some public pension plans are well funded, while others have seen their funded status decline.

Now another change is on the horizon: new pension accounting standards issued by the Governmental Accounting Standards Board (GASB) in 2012. GASB Statement No. 67, *Financial Reporting for Pension Plans*, takes effect for pension plan fiscal years beginning after June 15, 2013 (fiscal years ending on or after June 30, 2014). GASB Statement No. 68, *Accounting and Reporting for Pensions*, applies to employers (and contributing nonemployers) in fiscal years beginning after June 15, 2014 (fiscal years ending on or after June 30, 2015).

These new accounting standards will change the way public pensions and their sponsoring governments report their pension liabilities. In particular, the new standards no longer provide guidance on how to calculate the actuarially determined annual required contribution (ARC), which many governments have used not only for accounting, but also to budget their pension plan contribution each year. In fact, these new GASB accounting standards end the relationship between pension accounting and the funding of the ARC.

In addition to GASB's new accounting standards, policymakers should be aware that rating agencies such as Moody's may use yet another set of criteria to assess the impact of pension obligations on the creditworthiness of a municipal bond issuer. If the ratings agencies publicize their pension calculations, state and local officials would be faced with the challenge of interpreting three sets of pension numbers: an accounting number to comply with the GASB's financial reporting requirements, an actuarial calculation to determine funding requirements for budgeting purposes, and a financial analysis figure produced by bond rating agencies to evaluate and compare issuers of municipal debt.

This guide provides key facts about public pension plans, why it is essential to have a pension funding policy, a brief overview of the new GASB standards, and which issues state and local officials need to address. The guide also offers guidance for policy makers to use when developing their pension plan's funding policy.

Pension funding background

In the 1970s, it was not uncommon for state and local governments to fund their pensions on a pay-as-you-go basis. Following the passage of ERISA, which set private sector funding requirements, state and local officials took steps to fully advance-fund their pensions. They were further encouraged to meet their actuarial funding obligations by new accounting and reporting standards issued by the GASB in 1986.

The trend to improve pension funding continued over the next decade. When the GASB issued Statements 25 and 27 in 1994, employers were required to disclose information on plan assets and liabilities in their financial reports. More important, to comply with GASB, employers also had to disclose their actuarially determined ARC and the percentage of the ARC the employer actually paid. The GASB defined the ARC to include the normal cost of pensions for today's employees plus a contribution to pay for any unfunded liabilities, typically amortized over a maximum 30-year period. Paying the full ARC has been an important measure of whether or not a pension plan is on track to fund its pension promises.

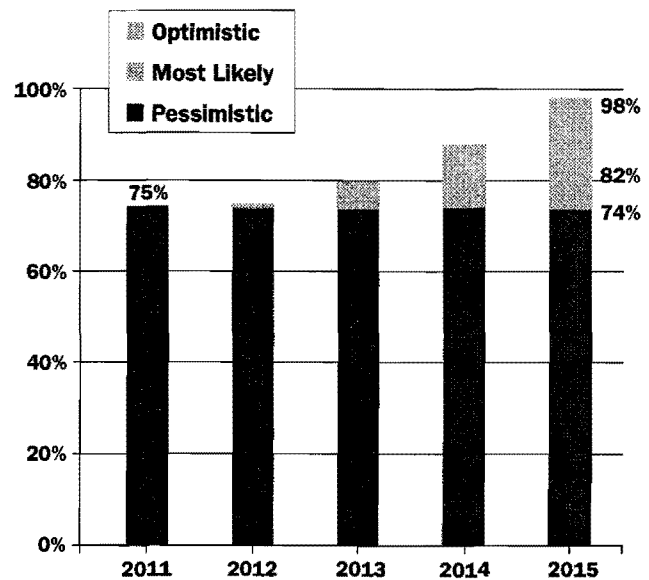
By the turn of the century, public pensions were as well funded as private pensions. In fact, most public plans were nearly 100 percent funded in 2000. Unfortunately, the last decade of economic upheaval and the wide swings in the stock market have reduced pension assets in both public and private plans.

In 2011, the estimated aggregate ratio of assets to liabilities slipped to 75 percent¹. State and local officials have stepped up their efforts to restore pension funding. According to the National Conference of State Legislatures, 44 states have enacted major changes in state retirement plans from 2009–2012.² Changes have included increases in employee contributions to pension plans, longer vesting periods, reduced benefit levels, higher retirement ages, and lower cost-of-living adjustments. Some modifications may apply to new workers only, while others affect current employees and/or retirees.

Pension funding policies

A variety of state and local laws and policies guide decisions concerning pension funding practices. Many state and local governments have passed legislation that stipulates how pensions should be funded. Others

Figure 2. Projected State and Local Funding Ratios Under Three Scenarios, 2011–2015



Source: BC-CRR estimates for 2011–2015 based on *Public Plans Database (PPD)*.

have policies that address how pension assets are to be invested or if pension reserves must be maintained.

Generally speaking, employers with well-funded pension plans take a long-term approach to estimating investment returns, adjust their demographic and other assumptions as needed, and consistently pay their annual required contribution in full.

A clear pension funding policy is important because it:

- Lays out a plan to fund pensions;
- Provides guidance in making annual budget decisions;
- Demonstrates prudent financial management practices;
- Reassures bond rating agencies; and
- Shows employees and the public how pensions will be funded.

GASB's new approach

Under prior GASB statements, there was a close link between accounting and funding measures. That link has now been broken. The new GASB standards

1 Munnell, Alicia H., Aubrey, Jean-Pierre, Hurwitz, Josh, Medinica, Madeline, and Quinby, Laura, "The Funding of State and Local Pensions: 2011–2015," Center for State and Local Government Excellence, May 2012.

2 Snell, Ron, "State Retirement Legislation 2009–2012," National Conference of State Legislatures, July 31, 2012.

focus entirely on accounting measurements of pension liabilities and no longer on how employers fund the cost of benefits or calculate their ARC. This is a significant change for government employers because the ARC historically served as a guide for policy makers, employees, bond rating agencies and the public to determine whether pension obligations were being appropriately funded. The ARC also often was used to inform budget decisions.

Today, employers report a liability on the face of their financial statements only if they fail to fully fund their ARC (just as a homeowner would report a liability only for mortgage payments in arrears). Thus, many government employers today do *not* report a liability for pensions on the face of their financial statements. However, if the plan they sponsor does have an unfunded pension liability, it is reported in the notes to the financial statements, which are considered an integral part of financial reporting. In contrast, under the new GASB standards, employers will report their unfunded pension liability on the face of their financial statements, even if they fully fund each year's ARC (just as a homeowner would report a mortgage liability even if all monthly mortgage payments are paid on time, in full). Thus, in the future, all employers will report any unfunded pension liability on the face of their financial statements, and that amount may be substantial for many.

Furthermore, those seeking to know how much an employer should be contributing each year to the pension plan and how much the employer actually contributed (funding information) today can find that information in the employer's financial report. In contrast, under the new GASB pension accounting standards, employers will no longer *automatically* be required to obtain an actuarially determined ARC and then include information concerning that amount and actual employer contributions in their financial report.

Filling the gap in funding guidance

Because the GASB's new standards focus entirely on how state and local governments should account for pension liabilities and no longer focus on how employers fund the costs of benefits or calculate their ARC, a new source of guidance is needed.

To help fill that gap, the national associations representing local and state governments established a Pension Funding Task Force (Task Force) to develop policy guidelines.

The "Big 7" (National Governors Association, National Conference of State Legislatures, Council of State Governments, National Association of Counties, National League of Cities, U.S. Conference of Mayors, and the International City/County Management Association) and the Government Finance Officers Association established a pension funding task force in 2012. The National Association of State Auditors, Comptrollers and Treasurers; the National Association of State Retirement Administrators; and the National Council on Teacher Retirement also serve on it. The Center for State and Local Government Excellence is the convening organization for the Task Force.

The Task Force has monitored the work of the actuarial community and the rating agencies, as well as considered recommendations from their own organizations to develop guidelines for funding standards and practices and to identify methods for voluntary compliance with these standards and practices.

The actuarial and finance communities have been working on the pension funding issues and will be invaluable resources as governments make needed changes. Indeed, the California Actuarial Advisory Panel and the Government Finance Officers Association have issued guidelines consistent with the Task Force's recommendations, but with a greater level of specificity. The Conference of Consulting Actuaries is also preparing similar guidance. State and local officials are encouraged to review the guidelines and best practices of these organizations.

It also is important to note that some governments with well-funded pension plans will determine that they need to make few, if any, changes to their funding policies, while others may face many challenges. Keep in mind that changes can be made over time. A transition plan can address changes that may need to be phased in over a period of years. For example, an employer or retirement board that currently amortizes its unfunded liabilities over 30 years could adopt a transition plan to continue that schedule (as a fixed, decreasing period) for current unfunded liabilities and to amortize any new unfunded liabilities over 25 years. In five years, that pension plan would have completed its transition to a 25-year amortization period.

In many cases, governments will need to strike a balance between competing objectives to determine the most appropriate timeframe in which to meet their goals.

Task force recommendations

States and localities have established distinct statutory, administrative and procedural rules governing

how retirement benefits are financed. While nothing in the new GASB standards or the possible credit rating agency changes *requires* a change in funding policy, the Task Force recommends pension funding policies be based on the following five general policy objectives:

1. Have a pension funding policy that is based on an actuarially determined contribution.
2. Build funding discipline into the policy to ensure that promised benefits can be paid.
3. Maintain intergenerational equity so that the cost of employee benefits is paid by the generation of taxpayers who receives services.
4. Make employer costs a consistent percentage of payroll.
5. Require clear reporting to show how and when pension plans will be fully funded.

A sound pension funding policy should address at least the following three core elements of pension funding in a manner consistent with the policy objectives:

- Actuarial cost method;
- Asset smoothing method; and
- Amortization policy.

These core elements should be consistent with the parameters established by GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*, with which most governmental entities currently comply. Such parameters specify an actuarially determined ARC that should comply with applicable Actuarial Standards of Practice (ASOP No. 4), be based on an estimated long-term investment yield for the plan, and should amortize unfunded liabilities over no more than 30 years. The actuarially determined ARC, the parameters for determining the ARC, and the percentage of the ARC the employer actually paid should be disclosed and reassessed periodically to be sure that they remain effective. To that end, the Task Force recommends that state and local governments not only stay within the ARC calculation parameters established in GASB 27, but also consider the following policy objectives when reviewing each core element of their funding policy:

Actuarial Cost Method: the method used to allocate the pension costs (and contributions) over an employee's working career.

Policy Objectives:

1. Each participant's benefit should be fully funded under a reasonable allocation method by the expected retirement date.

2. The benefit costs should be determined as a level percentage of member compensation and include expected income adjustments.

The Entry Age Normal (level percentage of payroll) actuarial cost method is especially well-suited to meeting these policy objectives.

Asset Smoothing Method: the method used to recognize gains or losses in pension assets over some period of time to reduce the effects of market volatility and provide stability to contributions.

Policy Objectives:

1. The funding policy should specify all components of asset smoothing, such as the amount of return subject to smoothing and the time period(s) used for smoothing a specific gain or loss.
2. The asset smoothing method should be the same for both gains and losses and should not be reset or biased toward high or low investment returns.

The use of a five-year period for "smoothing" investment experience is especially well-suited to meeting these policy objectives.

Amortization Policy: the policy that determines the length of time and structure of payments required to systematically fund accrued employee benefits not covered by the actuarial value of assets.

Policy Objectives:

1. The adjustments to contributions should be made over periods that appropriately balance intergenerational equity against the goal of keeping contributions level as a percentage of payroll over time.
2. The amortization policy should reflect explicit consideration of (a) gains and losses actually experienced by a plan, (b) any changes in assumptions and methods, and (c) benefit or plan changes.
3. The amortization of surplus requires special consideration consistent with the goal of stable costs and intergenerational equity.

Amortizing the various components of the unfunded actuarial accrued liability over periods that focus on matching participant demographics but also, except for plan amendments, consider managing contribution volatility, is especially well-suited to meeting these policy objectives.

Conclusion

The most important step for local and state governments to take is to base their pension funding policy on an actuarially determined contribution (ADC). The ADC should be obtained on an annual or biannual basis. The pension policy should promote fiscal discipline and intergenerational equity, and clearly report when and how pension plans will be fully funded.

Other issues to address in the policy are periodic audits and outside reviews. The ultimate goal is to ensure that pension promises can be paid, employer costs can be managed, and the plan to fund pensions is clear to everyone.

Resources

1. GFOA best practice, *Guidelines for Funding Defined Benefit Pension Plans*, at: www.gfoa.org
2. GASB Statements No. 67 and 68 at: www.GASB.org
3. GASB Statement 27: http://www.gasb.org/cs/ContentServer?site=GASB&c=Document_C&pagename=GASB%2FDocument_C%2FASBDocumentPage&cid=1176160029312
4. Moody's Request for Comments: Adjustments to US State and Local Government Reported Pension Data at: http://www.wikipension.com/wiki/Moodys_Request_For_Comments
5. National Conference of State Legislatures, changes to state pension plans at: <http://www.ncsl.org/documents/employ/2012-LEGISLATION-FINAL-Aug-31-2012.pdf>
6. The National Association of State Retirement Administrators for examples of state funding policies at: www.NASRA.org
7. Center for State and Local Government Excellence for examples of changes to state and local government pension plans at: <http://slge.org>
8. California Actuarial Advisory Panel at: <http://www.sco.ca.gov/caap.html>
9. Conference of Consulting Actuaries at: <http://www.ccactuaries.org/index.cfm>

The Long, Sorry Tale of Pension Promises

How did states and cities get into this mess? It's a simple case of human frailty; where to go from here

ROGER LOWENSTEIN

Fifty years ago, the auto industry suffered a massive pension bust. The numbers back then were small, but pension failures are never about the numbers—they're about human frailty. People are tempted to promise more than they can deliver. Today, cities and states across the country are way behind on the promises they made to their employees. Several—including Detroit—are in bankruptcy.

Back in 1963, Studebaker, an independent auto maker in South Bend, Ind. was struggling to compete with the Big Three. Desperate to stay afloat, the company had increased the benefits it was promising to its retirees four times in the 1950s and early 1960s. What was desperate about this? Pension benefits aren't paid out of thin air; sponsors are supposed to set aside a sum of money proportional to the benefits that will eventually come due. If the money is invested prudently, the fund will have enough assets to meet its obligations.

Here's the rub: While Studebaker was nominally increasing benefits, it hadn't the slightest hope of making the requisite contributions. The "increases" were a fiction, but when you have no cash, promising future benefits is the best you can do, whereas raising salaries is out of the question. The United Auto Workers was complicit in this fiction. Union officials reckoned that it was better to tell the members they had won an "increase" rather than to admit that their employer was going bust.

Studebaker halted U.S. operations at the end of '63, and the company terminated its pension plan. Workers saw the bulk of their pensions go up in smoke. The loss was devastating—\$15 million—and Washington didn't offer a bailout. People were shocked, though it isn't clear why. In 1950, when General Motors agreed to a pension plan, a young consultant named Peter Drucker had termed the landmark agreement a "mirage," doubting whether any company could anticipate its finances and the actuarial evolution of its workforce decades hence.

Planning wasn't the problem. Auto makers knew their pensions were underfunded—they simply preferred to spend their cash on sexy tail fins or executive bonuses. The Studebaker failure moved Congress to enact a remedy, although it took its sweet time, finally getting around to approving the Employee Retirement Income Security Act in 1974.

Erisa, as the law was known, required pension sponsors to pay annual premiums for pension insurance. It also mandated that companies actually fund their pension plans. "Mandated" is a term of art—it presumes the power to enforce. Alas, companies that found themselves in trouble tended to fall behind anyway. Over the ensuing four decades, most of the heavily unionized industries—steel, airlines, automobiles—suffered waves of bankruptcies and pension failures (now at least mitigated by insurance). Erisa provided some stability to corporate pensions, but not as much as hoped.

Public pensions—and here we come back to our current straits—replicated this behavior. Cops, firefighters and teachers had pensions well before most private-sector workers, but benefits weren't so high as to cause a problem, since government employers unilaterally set benefit levels (as well as salaries) without resorting to anything as unpleasant as collective bargaining.

By the time of the Studebaker collapse, however, matters were changing. New York City granted its employees the right to collectively bargain in 1958, and pretty soon, the genie was out of the bottle. In the 1960s, New York suffered a wave of public strikes, the resolution of which typically included pension increases. The city fathers reacted just as

Studebaker's executives had. By the time Erisa was passed, New York was on the verge of bankruptcy, but Congress didn't think to deal with public plans. Cities and states could do as they pleased.

Private pensions gradually faded as an issue because many employers with pension plans failed, and newer companies (read: Google) never started them. But the problem with cities and states has mushroomed. As of last year, public plans are unfunded by a cool \$1 trillion. Illinois is a poster child: \$100 billion in the hole. Plans in Connecticut and Kentucky are in bad shape, ditto Chicago, Pittsburgh, the bankrupt San Bernardino, Calif., and many other cities.

The temptation for governments to negotiate unrealistic benefits was even greater than in the private sphere. Elected officials knew that, by the time benefits came due, they would be out of office. Union officials knew it, too. Once benefits were agreed to, cities and states chose to skimp on funding. Politically, it was always preferable to build the extra school or staff the additional fire station than to squirrel away more pension money.

Much has been written about the poor investing performance of public pension plans. But for all the ill-conceived speculation of Calpers (the giant California fund) and others, the real problem is that politicians across the country have failed to fund. For them, the choice between raising taxes and keeping the pension fund solvent is no choice at all.

This is a pity because, when properly run, pensions remain the best form of retirement plan. They do away with many of the risks born by individuals alone, such as outliving one's savings or retiring at the wrong time. And most people don't have the expertise to manage portfolios.

Of course, if employers don't make adequate contributions, such advantages disappear. What happens then? In the private sector, customers walk and bankruptcy results. That is also what happened in Detroit: The city's taxpayer-customers left town. But Detroit is unusual.

Most communities will not lose half their populations, and most will not seek recourse in bankruptcy. Like it or not, governments will have to find a route to solvency. That will mean reduced benefits, higher taxes or, usually, a combination of the two. In the past few years, a reform movement has begun. Governments have begun to trim benefits—a few, such as Rhode Island, quite drastically.

What's needed is to impart a sense of urgency—to convince cities and states that pension underfunding has to be dealt with now, like any other fiscal shortfall. Illinois Gov. Pat Quinn has temporarily suspended legislative salaries to pressure lawmakers to enact pension changes—an inspired move.

But if you want governments to come clean, go after their drug of choice—credit. Detroit's bankruptcy has had a salutatory effect, pushing up interest rates for other cities with pension problems. If bond markets punish localities for not funding their pension plans, politicians will not be able to look the other way.

The trouble is, the bond market's memory is short. Before we get more Detroits, or more Studebakers, the federal government should enact an Erisa (with teeth) for public employers. More simply, it could announce that local governments that fail to make timely and adequate contributions to their pension plans would lose the right to sell bonds on a tax-free basis. That would get their attention.

The point isn't to punish public retirees. The point is that, when governments make contractual promises, they ought to fund them.